IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 1220

PHILLIPS, et al., *Petitioners*,

v.

THE BALTIMORE AND OHIO RAILROAD COMPANY, *Respondent*.

IN THE MATTER OF

THE BALTIMORE AND OHIO RAILROAD COMPANY, *Petitioner*.

In Proceedings for a Railroad Adjustment under Chapter XV of the Bankruptcy Act.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND.

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To the Honorable the Justices of the Supreme Court of the United States:

Your petitioners are Amy, Darius and Randolph Phillips, owners of $100,000 principal amount of the Convertible 4½% bonds due 1960 of the Baltimore & Ohio Railroad Company.[1]

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[1] Randolph Phillips is also attorney in fact for the owners of approximately $1,800,000 principal amount of these Convertible bonds. However, when proof of this representation was offered at the time of the hearing on the decree it was excluded on the ground that the record had already been closed.

Petitioners respectfully pray that a writ of certiorari issue to review the decree of the specially constituted three-judge United States District Court for the District of Maryland entered in this cause on March 13, 1946, approving and confirming a plan of adjustment for the B. & O. under Chapter XV of the Bankruptcy Act.

OPINIONS BELOW.

The report and order (T. 11)[1a] of the Interstate Commerce Commission (hereinafter called the I. C. C.) under Section 20a of the Interstate Commerce Act, authorizing the issuance and modification of the respective securities as proposed by the adjustment plan involved herein, are reported in 261 I. C. C. 51; its report and order (PX. 4, p. 97) authorizing the participation by the Reconstruction Finance Corporation (hereinafter called the R. F. C.) in said plan are reported in 261 I. C. C. 211. The opinion (T. 1549) of the special three judge District Court (Circuit Judges Soper[2] and Dobie and District Judge Chestnut) approving and confirming the plan is reported in 63 F. Supp. 542.

JURISDICTION.

The decree of the District Court was entered March 13, 1946. (T. 1936). A motion for a new trial was filed by petitioner Randolph Phillips on March 23, 1946 (T. 1990) and denied on March 27, 1946. (T. 2005). The jurisdiction of this Court is invoked under Section 745 of Chapter XV of the Bankruptcy Act, (11 U. S. C. § 1245).

[1a] Petitioners have moved the Court to dispense with the printing of the record for the purpose of considering this petition. References are therefore to the unprinted transcript, pages being preceeded by the letter T. — and exhibits referred to as OX (present petitioner's exhibits) and PX (B. & O. exhibits) plus a page number.

[2] Judge Soper was substituted for Circuit Judge Parker after the initial hearings in July but before the September hearings. No party in interest objected.

QUESTIONS PRESENTED.

1. Did the court err in finding that the plan involved herein is fair and equitable as an adjustment and as such will (a) afford due recognition of the rights of each class of creditors and stockholders and fair consideration to each class adversely affected and (b) will conform to the law of the land regarding the participation of the various classes of creditors and stockholders?

2. Did the court err in holding that the jurisdictional requirement that the petition be filed in "good faith" meant merely that there must not be "intentional fraud",[3] and did it err in making the findings of good faith required by Sections 714 and 725(5) of Chapter XV?

3. Did the court err in finding that the Company was "unable to meet its debts matured or about to mature", as those terms are used in Sections 710 and 714 of Chapter XV?

4. Did the court err in finding that the jurisdictional percentages of bondholders of each class had assented to and accepted the plan in view of (a) the absence of evidence that the authorizations assenting to the plan were executed by or on behalf of persons who held the bonds at the time of filing and approval of the plan and (b) unfair solicitation practices, in particular the misrepresentation as to the obligation of the bonds in the solicitation literature?

5. Did the court err in finding that the Company had satisfied the requirements of law and that the plan should be approved?

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[3] "But in this case the phrase, lack of 'good faith' is used in its primary sense of intentional fraud". In the Matter of the Baltimore & Ohio Railroad Company, 63 F. Supp. 542, at 557, fn. 16.

STATUTE INVOLVED.

Chapter XV of the Bankruptcy Act, commonly referred to as the McLaughlin Act, was approved October 16, 1942. It is substantially identical with the previous enactment of Chapter XV which was effective from July 28, 1939, to July 31, 1940. Chapter XV is an alternative to Section 77 of the Bankruptcy Act. It is designed for railroads in temporary financial difficulty and provides a procedure for the adjustment of debts of railroads not in equity receivership or under Section 77 reorganization.

The procedure under Chapter XV may be briefly described as follows: The Company prepares a plan and receives "assurances of acceptance" from creditors holding at least 25 per cent of the aggregate amount of all claims affected. It then obtains an order from the I. C. C. authorizing the issuance or modification of the securities as proposed by the plan. The I. C. C. is required to make limited findings relating generally to the feasibility of the plan and the public interest. Section 710(2) (11 U. S. C. Sec. 1210 (2). The I. C. C. is not required to make the crucial findings that the company is "unable to meet its debts matured or about to mature"[4] or that "the plan is fair and equitable as an adjustment and as such will (a) afford due recognition to the rights of each class of creditors and stockholders and fair consideration to each class adversely affected and (b) will conform to the law of the land regarding the participation of the various classes of creditors and stockholders".[5] These findings are required to be made only by the court. Section 725 (3) 11 U. S. C. Sec. 1225 (3).

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[4] The opinion of the I. C. C. (T. 15) clearly shows that it did not make a finding of inability to pay debts (see T. 64). Nor did the District Court rely on any such purported finding of the I. C. C. See also note 6, *infra*.

[5] The I. C. C.'s view that it has no responsibility with respect to the issue of what is fair and equitable under Chapter XV is set forth in *Delaware & Hudson Railroad*, 254 I. C. C. at pp. 240-241, as follows:

After obtaining an order from the I. C. C. and assents to the plan from two-thirds of the aggregate amount of the claims affected and from at least a majority of each class thereof, the Company files, for approval of the plan by a special three-judge court, a petition which must aver that the Company is unable to meet its debts matured or about to mature. Section 710(3), 11 U. S. C. Sec. 1210(3). The court is not permitted to appoint a receiver or trustee or to control the Company's operations. Section 715 (11 U. S. C. Sec. 1215).

The court is expressly required to scrutinize the facts independently of any findings by the I. C. C. If it makes the requisite findings, it enters an order approving the plan. Among these findings are (a) the "*Boyd* case" finding quoted above; (b) a finding that the plan and its acceptance are in good faith; (c) a finding that the requisite acceptances have in fact been obtained; and (d) a finding that the provisions for management are adequate and fair. Section 725, last paragraph (11 U. S. C. Sec. 1225).[6]

"It will be observed that while certain of these specific findings are the same as or similar to those which we must make in approving a plan of reorganization under Section 77 of the Bankruptcy Act, others definitely negative any concept that our functions in a proceeding such as this are as broad as those under a Section 77 proceeding in which we must find among other things that the plan conforms to the principles of"... [the *Boyd* case]. "This is also clearly shown by the legislative history of Chapter XV. For instance in the report for the House Committee on the Judiciary, adopted by the Senate Committee on Interstate Commerce, accompanying H. R. 7121, which became Chapter XV, it is stated: 'The public interest in the proceeding is protected by the finding of the Commission, after hearing, that the issuance or modification of securities as proposed conform to Section 20a. The private rights of creditors and stockholders are protected in the proceeding conducted by the three-judge court, and by its findings are required by Section 725 of the bill'."

[6] The findings required of both the I. C. C. and the court are as follows: (a) That the corporation is not in need of Section 77 reorganization; (b) That its inability to meet its debts is reason-

It should be noted that the solicitation of assents to the plan under Chapter XV is done by the management which also conducts the poll. By contrast, in Section 77 proceedings, solicitation is subject to the supervision of the I. C. C. (§ 77p) which itself conducts the poll and certifies the results to the Court (§ 77e).

The provisions of Chapter XV have expired except in respect of proceedings initiated before November 1, 1945, but legislation to extend its provisions has passed the House of Representatives and is pending in the Senate of the United States.[7]

STATEMENT.

The B. & O. railroad operates more than 6,000 miles of road. The aggregate par and stated value of its capitalization, including subsidiaries, exceeds one billion dollars. Its interest-bearing obligations are between five hundred and six hundred million dollars (including leasehold obligations). Approximately $500,000,000 of these obligations

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ably expected to be temporary only; and (c) That in the light of probable prospective earnings, the plan (i) is in the public interest and in the best interests of each class of creditor and stockholder, (ii) is feasible, financially advisable, and not likely to be followed by insolvency or reorganization or further adjustment, (iii) provides fixed charges which can be adequately covered by probable earnings, (iv) leaves adequate means for future financing and (v) is consistent with adequate maintenance of property and proper performance of the railroad's obligations to the public as a common carrier.

[7] A somewhat different bill (S. 1253, 79th Cong. 2d Sess.) which "adopts the basic principle of the Chapter XV procedure in authorizing reorganizations without forfeiture of either bonds or stock" (S. Rep. No. 1170, 79th Cong. 2d Sess., p. 145) was reported favorably to the Senate. S. 1253 is designed to supersede the "outmoded and condemned" Section 77 procedure (S. Rep. No. 1170, *supra*, at p. 11) and would remove from Section 77 and place under the new procedure—basically similar to Chapter XV—pending 77 proceedings of certain major railroads including the Denver and Rio Grande, The New Haven, and Missouri Pacific among others.

are affected by the Plan, and are held by some 80,000 owners of whom only 39,000 are listed by the Company as assenting to the plan (PX. 101, p. 2261).[8] In addition, the Company has outstanding more than $256,000,000 par value of common stock and more than $58,000,000 par value of preferred stock.

This is the second time within a period of six years that the railroad has sought relief under the provisions of Chapter XV and its predecessor statute. We shall set forth briefly the facts concerning earlier proceedings as well as the present ones.

The 1939 Plan.

Less than six years prior to the filing of the present petition, an adjustment plan for the B. & O. under Chapter XV of the Bankruptcy Act was approved.[9] 29 F. Supp. 608.[10] The chief characteristic of the 1939 plan was an eight year moratorium for the payment of interest charges on certain of the railroad's bond issues, including the Convertibles of 1960 which are further affected by the instant plan. In neither the 1939 plan nor the present plan were the contractual rights of the preferred or common stockholders altered, nor were their assents to the plan solicited.

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[8] This would indicate that there are 41,000 non-assenting security holders. The court suggests that some of these may be in Europe and difficult of access, but there were only $17,000,000 of these securities held in Europe, as of 1939. (29 F. Supp. 608, at 617), and the court in the present proceeding found "no definite evidence" regarding the number of bondholders in the armed services. 63 F. Supp. 542, at 569.

[9] The period between proceedings is so short that it would have barred a discharge to an ordinary bankrupt. (Sec. 14 (c) 5 of the Act, 11 U. S. C. Section 32 (c) 5).

[10] Certiorari denied *Getz* v. *B. & O. R. Co.*, 309 U. S. 654; rehearing denied, 309 U. S. 697. Although some attempt was made by the petitioner in that case to raise the *Boyd* case issue, in opposition the B. & O. took the position that this issue was not in fact raised and that the only question before the court on certiorari would be the separate classification of assented and unassented bonds. See p. 7 of B. & O. Brief in opposition No. 625, 1939 Term.

The 1939 plan provided for extending until **August 1,** 1944, and November 8, 1944, obligations amounting to approximately $122,000,000, of which $85,000,000 was due to the Reconstruction Finance Corporation for loans previously made and maturing in 1939-1942. These loans were secured by a large amount of collateral.

In seeking approval of the 1938 plan, the Company represented and the court found that the inability of the B. & O. to meet its debts was reasonably expected to be temporary only, and that, on the basis of prospective earnings, the plan would not be likely to be followed by need of further financial reorganization or adjustment, that it did not provide for fixed charges in excess of probable earnings, and that it would leave adequate means for future financing. The court further found that the 1944 maturities could be met. Its opinion states that they could be refunded "through an anticipated increase in earnings with a consequent increase in market value of the securities . . . constituting the collateral pledged for the loans" (p. 545 of 63 F. Supp.).

In its order approving the 1939 plan, the court below enjoined the B. & O., the RFC and all others from taking action by the institution of judicial proceedings "or otherwise in any way without limitation" inconsistent with the provisions of the plan. Nevertheless, before the expiration of the eight year period of the 1939 plan, without applying for or seeking a modification of the injunction, the Company instituted these proceedings by petition filed on December 4, 1944 with the I. C. C.

The Period Between Plans.

In the years from 1940 through the first eight months of 1945 (PX. 1, p. 29, PX. 88, p. 2011) petitioner's aggregate net profits after payment of all taxes and fixed and accrued contingent charges totaled approximately $116,000,000.[11]

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[11] See note 12, *infra.*

The four years 1941-1944, inclusive, represent the most profitable period in the Company's entire history.[12]

Nevertheless, the Company upon filing the present proceedings represented that it was unable to meet obligations to the RFC maturing in 1944 in the amount of $81,000,000. It should be noted that during the period between the approval of the first Chapter XV plan and the present plan, (1) the collateral securing the $81,000,000 debt to the RFC increased in market or appraised value from $70,000,000 to a total of $162,000,000 as of December 26, 1944; (2) net working capital increased from a deficiency of $13,000,000 as of July 31, 1939 to a favorable balance of approximately $70,000,000 as of December 31, 1945; (3) the cash and cash assets as of December 31, 1945, exceeded $83,000,000 compared with only $8,000,000 as of July 31, 1939; (4) in 1943 and 1944—before the RFC loans became due—the Company with the prior knowledge and approval of the Federal Loan Administrator used some $31,500,000 in sinking fund and other moneys for the retirement of bonds maturing in the years 1948, 1950, 1951, 1957, 1959, 1990, 1995 and 2000, instead of applying the funds to reduction of the RFC loans; (5) accruals for depreciation of equipment and amortization of equipment and road properties from 1940 to 1944, inclusive, totaled more than $64,000,000.

The Present Proceedings.

On December 4, 1944, a petition as provided by Chapter XV was filed with the I. C. C. as the first step in securing approval of the present plan. The I. C. C. made the necessary findings in an order dated March 12, 1945 and authorized the issuance of securities to consummate the adjustment plan. Petition for approval of the plan was filed in the District Court on July 2, 1945.

The plan provides in substance for the extension of the maturity of the major bond issues of the B. & O. system

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[12] The equity of the stockholders was further increased by the retirement of approximately $100,000,000 of principal amount of system debt at a cost of about $68,000,000.

aggregating $495,799,164, the conversion of these bond issues, in whole or in part, from fixed interest to interest contingent as to payment upon earnings and the modification of the indentures securing these bonds to permit the creation of additional prior lien debt. In substance, the RFC debt was extended for twenty years, the first mortgage debt extended for twenty-five years, and the unsecured obligations extended for fifty years.[13] The second lien

[13] The following table, copied from the lower court's opinion shows the extension dates and interest treatment of the securities affected by the plan:

Description	Principal amt. Outstanding	Adjustment proposed in plan
Secured notes, matured Aug. 1, 1944, and November 8, 1944	$82,393,114*	Extended to 1965 by refunding
First Mortgage, 4% Bonds, due July 1, 1948	76,922,350	Extended to July 1, 1975
First Mortgage, 5% Bonds, due July 1, 1948	67,826,500	Extended to July 1, 1975, 1% unsecured interest to be contingent but cumulative
Southwestern Division Bonds, due July 1, 1950	37,285,500	Extended to July 1, 1980, 1½% unsecured interest to be contingent but cumulative
Pittsburgh, Lake Erie & West Virginia Bonds, due Nov, 1, 1951	36,798,000	Extended to Nov. 1, 1980
Toledo-Cincinnati Division 4% Bonds, Series A due July 1, 1959	10,028,700	Extended to July 1, 1985
Refunding and General Mortgage Bonds:		
Series A, 5%, due December 1, 1995	48,989,000	After 1946 interest on A. D. & F. to be 2% fixed and 3% secured contingent; and C to be 2-2/5% fixed and 3-3/5% secured contingent
Series C, 6%, due December 1, 1995	29,218,500	
Series D, 5%, due March 1, 2000	22,390,000	
Series F, 5%, due March 1, 1996	22,041,500	
	122,639,000	
Thirty year 4½% Convertible Bonds, due February 1, 1960	61,906,000	Extended to Feb. 1, 2010, 4½% unsecured interest to be contingent but cumulative
	$495,799,164	

* Reduced to $81,600,000, as of May 28, 1945, by collections on collateral (PX. 4, p. 98.)

bonds (Refunding and General Mortgage Bonds) whose maturity dates before the plan were between 1995 and 2000 were not extended but a portion of their fixed interest was made contingent.

The most drastic alteration was in the Convertible Bonds represented by your petitioner. These are extended for fifty years, so that they become due in the Twenty-first Century, *i.e.* 2010, and the entire interest on the bonds for that whole period is made contingent on an annual basis instead of fixed and payable semi-annually. Unpaid interest is made cumulative. In addition, a Capital Fund and a First Sinking Fund are placed ahead of the Convertibles as a charge on earnings. Further, the protection which the Convertible bonds had in the form of a covenant that no new mortgage might be created without ratably securing the Convertibles has been rendered nugatory with respect to additional bonds for new financing permitted by the plan. Plan Art. 5, Sec. 5.

The plan makes no alteration of the contractual rights of preferred and common stockholders. Indeed, no vote of the stock interests on the plan has even been sought.

A statutory three-judge court was convened and hearings were held in July and September, 1945. Your petitioner, Randolph Phillips, appeared below and introduced evidence to show among other things that the plan was unfair and inequitable, in violation of "the law of the land" as reflected by decisions of this Court; that the Company's petition was not filed in good faith; that the Company could not support the allegation that it was unable to meet its obligation to the RFC; that the assents to the plan were obtained pursuant to the misrepresentation that interest on certain of the bonds (including the Convertible) was then contingent; and that the large and unprecedented volume of trading which had taken place in the affected securities invalidated the assents obtained prior to the hearings on the plan in the absence of proof that such securities were still held by those who had executed the

consents. On the issue of good faith, your petitioner in addition to evidence of exceptionally good financial condition of the Company (*supra*, pp. 8-10) introduced testimony showing that the collusive character of the proceeding was so flagrant as to lead to the resignation of the Company's General Solicitor, Cassius M. Clay, and its Special Counsel, Colonel Henry W. Anderson (See *infra*, pp. 24-26).

The statutory court on November 20, 1945 handed down its opinion approving the plan in the form submitted by the B. & O. It ruled that the plan was fair and equitable, that the petition was filed in good faith, that the B. & O. was unable to meet its debts matured or about to mature and rejected all suggestions for amendment except that it modified the plan to provide that one member of the Board of Directors shall be elected by the stockholders "to represent" the Convertible Bonds "if a reasonably suitable nomination is made therefor by the Trustee" for the Convertible issue.[14] 63 F. Supp. 542 at 568. The decree was entered on March 13, 1946. A petition for rehearing was filed by Randolph Phillips on March 23 and denied on March 27. Your petitioners are asking a review of the orders of the District Court.

REASONS FOR GRANTING THE WRIT.

I.

In deciding that the plan submitted by the Company "is fair and equitable as an adjustment" and will "afford due recognition to the rights of each class of creditors and stockholders and fair consideration to each class adversely affected," and "will conform to the law of the land regarding the participation of the various classes of creditors and

[14] The Convertible bondholders, of course, have no voice in the selection of the Trustee or director, and trustees under indentures cannot be relied upon to be truly representative of bondholders. See Report of Securities and Exchange Commission on Protective and Reorganization Committees, Part VI, pp. 71-109.

stockholders" (Section 725, Clause 3),[15] the District Court has decided the instant case in sharp conflict with the applicable decisions of this Court, and in conflict with the decisions of other three-judge federal district courts under Chapter XV. This Court has not reviewed any reorganization under Chapter XV, and it is essential, we submit, that it declare the applicable principles and standards to be applied under that Chapter and related legislation.

There can be no question that the Congress intended by use of the language quoted above to make applicable the doctrine of the *Boyd* case. *Northern Pacific Ry. Co.* v. *Boyd*, 228 U. S. 482; see also, *Case* v. *Los Angeles Lumber Products Company*, 308 U. S. 106; *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448; *Group of Institutional Investors* v. *Chicago, Milwaukee R. Co.*, 318 U. S. 523; *Otis & Company* v. *Securities and Exchange Commission*, 323 U. S. 624. This is clear from the committee reports in both the Senate and the House (S. Rep. 498, 76th Cong., 1st Sess., (1939); H. R. Rep. 2177, 77th Cong. 2d Sess. (1942); S. Rep. 1617, 77th Cong., 2d Sess. (1942)). The Senate report on the present bill reprints the House Report, including the following language:

> "It is not contemplated that any plan of adjustment can be approved by the court for railroad companies where the continued participation of stockholders in the company can be maintained only at the sacrifice of substantive rights of creditors. The bill provides that the plan must conform to the requirements of the law of the land with reference to the participation of stockholders and creditors, and this provision has been interpreted to require that the plan must conform to the principles of *Northern Pacific Ry. Co.* v. *Boyd* (228 U. S. 482)."

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[15] It will be recalled that the ICC does not pass upon the fairness of the plan under Chapter XV in light of the principle of the *Boyd* case. (See *Delaware & Hudson Ry. Corp., Debt Adjustment,* 254 ICC at pp. 240-1, quoted *supra*, note 5.)

Other district courts have found applicable and have applied the *Boyd* case tests. See e.g. *Delaware & Hudson Ry. Corp* v. *Dancey,* 51 F. Supp. 763, 765 (SDNY 1943).

Although the attention of the court below was called at length to the requirements of the *Boyd* case and cases which reiterate and apply its doctrine, the court did not cite or refer to a single precedent, and in clear departure from them it approved a plan which provides for issuing inferior securities to bondholders without compensation for the sacrifices in the quality of their securities. In the case of the Convertible bonds of 1960, represented by your petitioners, the plan (a) extends their maturity for fifty years or until the year 2010, thereby making them the last of the Company's bonds to mature by postponing their maturity beyond the maturities of the Refunding and General Mortgage (2d lien) Bonds, and destroying their strategic position; (b) converts their fixed interest to contingent interest —not merely for the remaining 15 years of the original life of the bonds, but for the full extended period of 65 years; (c) changes protective features of its Convertible and other bond indentures so as to permit the issuance of large amounts of additional bonds which will be prior to the Convertibles; (d) creates a capital fund and a first sinking fund payment which increase the claims on the earnings prior to the claim of the Convertibles for contingent interest, which funds have the effect of improving the position of stockholders without proportionate benefit to the Convertibles;[16] (e) The provision for the payment of inter-

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[16] The Capital fund created by the plan is to be used for additions and betterments. The First Sinking Fund payment is to be used to retire senior debt. It *may not* be used to purchase or retire Convertible Bonds. It is obvious that the earnings diverted from the Convertibles to the Capital fund are of primary benefit to the stockholders whose position is dependent upon the long-range operations of the Company, and not to the bondholders who are comparatively short-term creditors. As to the first sinking fund payment, although it is to the interest of the Convertibles to have senior debt retired, it requires no argument to show that the diversion to this purpose of earnings which, absent the plan, would be avail-

est on the Convertibles postpones the payment of such interest, even if earned, until at least May 1 of the year after it has been earned. None of the interest due the Convertibles is paid during this period of deferment which is at least nine to fifteen months. The effect of this is a compulsory loan, interest free, by the Convertibles to the Company and the stockholders.[17] (f) The plan completely deprives the Convertible bondholders of the fortification of their position provided by the Company's present huge accumulation of cash. Without the plan, interest would be paid on the bonds currently when due even when not earned out of this large reserve. Under the plan when interest is not earned the bondholders must await a period—which may be many years—until it is earned. None of the present reserve or any future reserve earned in years prior to an interest deferment will be available to the Convertible bondholders.

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able for the Convertibles, deprives the Convertibles of a valuable right to the direct payment of such earnings to them.

The second sinking fund payments are a charge upon earnings after the payment of fixed charges, capital fund and contingent interest. These payments are to be used to retire, by purchase or call, senior bonds, and a part *may* be used to retire a limited amount of Convertibles; and not in excess of 50 per cent of the fund may be used to create and maintain net working capital and for capital investments.

The third sinking fund payments consist of amounts equal to dividends paid, but these sinking fund payments are to be discontinued when System charges for interest and guaranteed dividends (on rentals) fall below $20,000,000 annually. These now amount to about $26,000,000. These payments are usable for the same purposes as the second sinking fund payments.

It is obvious that none of these provides a real cushion for the Convertibles. Indeed, it should be noted that there is no provision whatever for obligatory retirement of Convertibles out of any of the funds, despite the fact that the 1st sinking fund payments are senior to interest payments on the Convertibles. Thus the so-called dividend "restrictions" may evaporate, in effect, while the sacrifices made by the Convertibles remain permanent until the year 2010.

[17] The provision for contingent interest on a yearly basis may result in earnings earlier in the year during what was formerly a semi-annual interest period being wiped out as a result of losses during later operations in the same year.

For these sacrifices, the Convertibles received no compensation. The preferred and common stocks of the Company were not altered in any way. Certain restrictions were placed on the management's dividend policies (discussed *infra* pp. 18-19) but the management was unaffected except as noted above.[18] No cash payment was made to the Convertibles; no stock or rights were given to them; no sinking fund was set up for the mandatory retirement of the Convertibles; and no control of management is given them when interest is unearned.

The reasoning of the Court below is reflected in the following quotation from its opinion:

> "The plan does not reduce the principal amount of the capital debt or the obligation of the Railroad for the full interest contracted for thereon, nor does it impair any of the present security for the several affected issues respectively. It merely *postpones* the maturities of the obligations for the principal and possibly some of the interest thereon. With respect to the latter it does not release the railroad from its absolute obligation eventually to pay all that has been contracted for although some portion of the original contract rates is made contingent as to time of payment, dependent upon the sufficiency of current net income . . ." (63 F. Supp. at 551, 552) (Italics in original)

But the court ignored the fact that the substitution of a contingent return for a fixed return and the extension of maturity is a loss of rights of value for which full compensatory provision must be made. See *Consolidated Rock Products Co.* v. *DuBois,* 312 U. S. 510, 527, 528, where this court stated:

> "But the bondholders have not been made whole. They have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of preferred

[18] See page 12, *supra.*

> stock, and their former strategic position has been weakened. Those lost rights are of value. Full compensatory provision must be made for the entire bundle of rights which the creditors surrender."

The fact that in the present case the interest is cumulative does not alter the case. The Convertible bondholders are by their contract entitled to fixed, semi-annual interest payments. If we assume that under the cumulative feature of the plan, all of the contingent interest will ultimately be paid in the year 2010 or earlier, nevertheless the following points should be noted:

(1) As shown above, *supra* p. 15, the Convertibles are completely deprived until the year 2010 of access to the cushion of earnings represented by the huge reserve funds of the Company. No compensation is made for this loss.

(2) Even if the interest is ultimately paid by reason of its being cumulative, each deferment of a payment represents an involuntary loan of money, interest-free, by the Convertibles to the stockholders. No provision is made for compensation for the unpaid interest. This practice may continue over a period of 65 years—until 2010.

(3) At the very least, the plan destroys the strategic position of the Convertibles. See *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, 527, 528. The loss of the right to fixed interest involves surrender of all control over their investment until 2010, the date of maturity. For fixed interest gives a right to institute proceedings for the protection of the investment, whereas contingent interest gives no such right. Accordingly, under the plan the Convertibles may have to stand by, powerless until 2010, witnessing the dissipation of the assets of the Company to their damage.

Indeed, the contingent interest provisions provide even less protection than is usual for preferred stocks approved by the I. C. C. and S. E. C., which provide for substantial representation in management in good years and control

of management in the event of default in dividends for a specific period. See e.g. *St. Louis, San Francisco R. Co.*, 257 I. C. C. 399; *El Paso Electric Co.*, 8 S. E. C. 366, 370, 371.

In contrast, the position of the stock is improved by the creation of a capital fund and sinking funds which may be used for the retirement of debt through tenders or open market purchases. In Chapter XV proceeding for other railroads hitherto decided by the District Courts, the plans require that the sinking funds be used to retire the specific bond issue whose interest or maturity date is changed. Only in the case of the B&O is there no such mandatory requirement, as in the treatment of the Convertibles. And it must be noted that contingent interest provisions without adequate safeguards for bondholder control on non-payment invite the accrual of unwarranted reserves to conceal the existence of actual earnings and to improve the equity position.

Some mention is made by the court of dividend restrictions imposed by the plan but these merely limit the management's discretion in the interest of conservative operation of the Company. In effect, they amount to restrictions upon the management's allocation and use of net earnings. They do not take from the stockholders any of their contract rights, but merely specify the manner in which available net earnings shall be used to improve the equity position by application to specified purposes.[19] Without any plan it is assumed that management would be prudent enough to allocate the necessary funds for capital and sinking fund purposes. The unique character of the present

[19] The plan provides an elaborate scheme for the application of net income. The requirements for all sinking fund payments may fall as low as $2,500,000. The only dividend restriction in the plan is a temporary requirement that an amount equal to dividends paid shall be paid into the sinking fund to be used for additions and betterments as well as debt retirement. These payments need not be made when charges for interest and guaranteed dividends (on stocks of leased lines) fall below $20,000,000 annually. Such charges are now about $26,000,000.

plan is that it takes valuable rights from bondholders in return solely for actions which are normal incidents of competent management. The preferred stock is still entitled to its 4 per cent, undiminished; and the common stock is still entitled to undiminished control[20] and to full, undiminshed dividends after provision for interest and charges. None of the rights or equities of either class of stock is given to or shared with the Convertibles as compensation for their sacrifices. Thus although the bonds are derogated to the position of a preferred stock, they are nevertheless not endowed with any of the advantages implicit in preferred or common stocks. They must share all the risks of stocks but none of the profits.

As for the sinking fund, its benefit to the Convertible bonds is uncertain at best. Not one cent of the first sinking fund payment (Paragraph 2, Article III of the Plan) is *permitted* to be used to retire Convertible bonds; and not one cent of any of the other sinking funds is *required* to be used for that purpose. Because there is an existing equity value in the stock, these funds, like the Capital Fund, serve in effect merely to enhance that equity.

The Court below conceded (p. 561 of 63 F. Supp.) that the bonds had made "concessions, or, if you please, sacrifices." No argument is made that any concessions of substance are made by the stockholders. And indeed the advantages to stockholders are so clear and the lack of concessions by them so obvious that no vote of stockholders on the plan was deemed necessary.

Some resort is had in justification of the court's treatment of the Convertibles to "realistic conceptions of railroad financing." (P. 562 of 63 F. Supp.)

Thus it is argued that since actual foreclosure of a railroad is an impossibility and since actual payment of inter-

[20] See page 12 and footnote 14, *supra*.

est is dependent upon earnings there is in substance no difference between fixed interest and contingent interest and that likewise there is in substance no difference between a debenture and a preferred stock.[21] But this argument proves too much. It ignores the value of fixed interest claims, of early maturities and of priority over equity interests, whether the company remains solvent or undergoes further reorganization. Indeed, if adopted, this argument would destroy the rule of the *Boyd* case and make stock interests alone invulnerable in reorganization. Logically, the inability to insist on fixed interest payments finds a parallel in the impossibility of foreclosure on property used in railroad operations. Under such an argument, the first, the second and third mortgage on railroad property would be no better than unsecured debt and neither the date of maturity, near or far, nor the character of the interest requirement, fixed or contingent, would be relevant. Indeed, since debt claims could be altered without altering stock interest in a reorganization a first mortgage bond would be a much less desirable security than a preferred or a common stock. In short, the argument that date of maturity and fixed or contingent character of interest are of no consequence is valid only if contracts are meaningless and the courts are free to do as the court below did and ignore the doctrine of the *Boyd* case.

Nor is there anything in Chapter XV which requires alteration of the standards of the *Boyd* case. In *Delaware and Hudson Railroad Corporation* v. *Dancey*, 51 F. Supp. 763 (S. D. N. Y. 1943), the District Court for the Southern District of New York approved a plan in 1943 by which

[21] The views of Commissioner Mahaffie of the ICC cited to support this view (See n. 23, p. 562 of 63 F. Supp.) have no relevance to the thesis for which they are cited. The fact that a regulatory agency may regard it as undesirable to burden an enterprise with fixed obligations does not mean that, once created, such fixed obligations should be treated as though they were not fixed.

the Delaware and Hudson was enabled to survive a crisis in its affairs. Only one mortgage was involved and its life was extended for only twenty years while in all other respects it was left undisturbed. Even so, the plan provided that the company make a ten percent cash payment of matured principal and increase the security by the deposit of additional collateral under the mortgage. It also provided a stiff sinking fund arrangement to assure retirement of the bonds, restricted dividends to one-sixth of net income and further provided that the company should use part of the proceeds of the sale of certain securities in further debt reduction. The court also held that because these securities had increased in value since the date of the ICC's action on the Company's application all proceeds in excess of $5,000,000 as well as the half of the first $5,000,000 of such proceeds, should likewise be used for debt retirement. See also *Group of Institutional Investors v. Chicago, Milwaukee, etc.*, 318 U. S. 523.

Under the B. & O. plan the Convertible bonds, although they retain the designation "bonds," are, to all intents and purposes, derogated to little more than the position of a preferred stock. Like a preferred stock, they have no maturity date, for certainly extension into the first decade of the 21st century is for all practical purposes an obliteration of their maturity date. Like a preferred stock also, they receive no annual payments unless earned. Their security in both earnings and assets is diluted. Their relative priority in maturity prior to the Refundings is abolished. Their absolute priority in earnings to charges for sinking and capital fund purposes is wiped out. Their absolute priority to enforce payment of unearned interest currently and of their principal in 1960 out of the stock equity is totally eliminated. By the principles of fairness and equity, they must receive full compensation for this treatment, and the present plan gives no such compensation.

The Company has also argued that the Convertible bondholders "receive 'fair consideration' in what is offered

them through the Plan by other classes of creditors of superior right." The concessions by issues senior to the Convertibles are irrelevant to the question here being presented since it is clear that the Convertible bondholders are receiving less than the equitable equivalent of what they surrender while the equity interests remain untouched. But the "fair consideration" cited by the Company as moving from the stockholders does not meet the test of the rule of strict priorities as enunciated by the decisions of this Court. The only features of the plan to which the management specifically refers—the capital and sinking funds and the dividend provisions discussed above, are in the category which this Court dismissed in the *Milwaukee* case, 318 U. S. 523, 567 by saying that they are merely "incident to a normal and proper operation of the road."

To permit the present plan to stand would mark a substantial erosion of the fixed principle of the *Boyd* case. It would serve as a precedent for reorganizations under Chapter X and Section 77 of the Bankruptcy Act and under Section 11 (e) of the Public Utility Holding Company Act of 1935. There can be no doubt that if the Baltimore & Ohio plan is permitted to stand the courts will be faced with many others, patterned upon it. Instead of continuing or reinforcing the traditional principles of fairness and equity insisted upon by the precedents of this Court, such plans will represent ingeniously contrived escapes therefrom.

II.

In deciding that the petition in the instant case was filed in good faith, the court decided the question in conflict with the decisions of this Court and by the use of an erroneous standard. The court below approved the petition in the present case on the assumption that lack of good faith could be established only by a showing of "intentional fraud." (fn. 16 at p. 557 of 63 F. Supp.) The court concedes that its ruling is in conflict with the broader construction given the same phrase in other statutes such as Chap-

ter X of the Bankruptcy Act, but gives no reason for a narrower construction under Chapter XV.

The court's view turns an affirmative requirement of the statute that the petition be filed in good faith into a nullity except in cases where an objector can carry the burden of showing "intentional fraud". Such a construction sanctions the collusive management plan under the device known in earlier days as the "friendly receivership", and repeatedly outlawed by decisions of this Court. See e.g. *Harkin* v. *Brundage*, 276 U. S. 36, 54, 55; *National Surety Co.* v. *Coriell*, 289 U. S. 426. In the instant case the court has blindly followed the guidance of management and violated the injunction of this Court, in the *Coriell* case, *supra*, that "Every important determination by the court in receivership proceedings calls for an informed independent judgment" (at p. 436).

In *First Nat. Bank* v. *Flershem*, 290 U. S. 504, this Court, through Brandeis, J., strongly condemned a similar device. In that case, despite the allegations of the company that it could not satisfy overdue interest charges without jeopardy to its ability to continue in business (p. 512) and despite the findings of the court below, this Court held that "The substantive law affords no warrant for so abridging the rights of individual creditors" (p. 518). It was held that the purpose and effect of the reorganization was "to hinder and delay certain creditors." (p. 518). And Mr. Justice Brandeis said that this was "fraudulent in law" (p. 518) even though the company sought to justify resort to the courts on the grounds that the reorganization would benefit bondholders as well as stockholders (p. 517).

A brief review of the circumstances of the filing of the present plan will demonstrate that it, just as the proceedings in the *Flershem* case, requires judicial condemnation as a deliberate endeavor of the Company, in violation of the "good faith" requirements of equity and Chapter XV, to use the judicial process to hinder and delay creditors.

It will first be recalled that only a few years before the inception of these proceedings, the Company had received

approval of another "adjustment" plan under Chapter XV, the Company representing and the Court finding that its inability to meet its debts was temporary only; that it would not be likely to be followed by need of further adjustment; that it did not provide for fixed charges in excess of probable earnings, and that it would leave adequate means for future financing. The court further found that the 1944 maturities could be refunded "through an anticipated increase in earnings with a consequent increase in market value of the securities . . . constituting the collateral pledged for the loans." 63 F. Supp. at 545.

It will also be recalled that the actual earnings subsequent to the plan were enormously higher than any that could have been anticipated (*supra*, pp. 8-10), and that the market value of the securities constituting the collateral for the loans maturing in 1944 actually doubled in value in the years between the plans, until its value as of December 26, 1944 was approximately twice the amount of the RFC debt.

Nevertheless, the record shows that as early as 1942—two years before the present proceedings were brought—the Company's management was already considering a readjustment under the provisions of enabling legislation which they anticipated that the Congress would provide. (T. 344-347, 836-838). This legislation took the form of a reenactment of Chapter XV, approved on October 16, 1942. The Company then proceeded, without regard to the statute's requirement of "good faith," to bring about an apparent inability to meet debts to the RFC, maturing in 1944, in the face of its excellent financial condition, without precedent in the Company's history. (*Supra*, pp. 8-10).

The facts showed so clearly that the "crisis" in the Company's affairs was entirely synthetic and that it was precipitated by the management's desire to manipulate the position of the bondholders, that two of the Company's chief counsel resigned in protest. On September 15, 1945, two days before the September hearings on the plan, Cassius M. Clay, General Solicitor of the B. & O., and counsel

for the RFC in the 1939 proceeding, submitted his resignation to the B. & O. stating that the present proceeding was "unsound both from a legal and a moral point of view," and that he was unwilling to accept any responsibility for it. When called as a witness in the proceedings below, Mr. Clay, upon cross-examination, characterized the initiation of the proceeding as a "frame-up" and stated that he did not think "an honest effort was made to meet the maturity in any way" (T. 1206; OX 20, p. 3419).[22]

Six days after B. & O. announced the promulgation of its second reorganization plan Colonel Henry W. Anderson, of Richmond, Virginia, Chief Counsel for B. & O. in the 1939 proceedings, asked to have a monthly retainer which he was receiving from the B. & O. terminated (PX 112, p. 2882). In a letter to Governor Cornwell, General Counsel, Mr. Anderson wrote "It was stated (in 1939) in effect by the management that if the plan was approved and put into effect . . . that the RFC loan or so much thereof as was not retired in the meantime, could readily be renewed or extended at maturity. This fact found further support in the known policy of the RFC never to use obligations of railroads to force them into bankruptcy. The Court predicated its approval of these provisions of the plan upon these assurances (See opinion October 9, 1939, pages 37-38).

"The expectations of the management as to the results of the operation of the (1939) plan and the improvement in the position of the company have been more than realized . . . I am constrained to feel that my continuance as counsel

[22] Attention is directed particularly to the extensive memoranda covering the events of the two years prior to the September, 1945, hearings which were prepared by Clay and received in evidence in support of his oral testimony. (OX 20, pp. 3429-3471)

for the company in these circumstances could not fail to cause me embarrassment." (PX 112 pp. 2284-6)[23]

Neither of these eminent attorneys, intimately familiar with the prior plan and the Company's affairs, was willing to be associated with a proceeding which lacked the basic ingredients of good faith. But the court below was willing to accept the unjustified disregard of its order in the 1939 proceedings, and misled by its view that "good faith" was established unless an objector showed "intentional fraud," refused to reject the petition. By adopting and applying this definition of "good faith" it has reopened the door to management manipulation and the destruction of the rights of creditors which characterized the unsavory era of friendly receiverships. This it has done despite the rulings of this Court in cases some of which are cited above, and despite the obvious adoption of the rule of those cases by the Congress in the "good faith" requirements of Chapter XV.

A brief enumeration of facts of record will show in more detail why Mr. Clay and Colonel Anderson refused to be associated with the proceeding or with the management that had the temerity to initiate it:

1. The earnings of the war years between plans were phenomenal. From 1940 through the first eight months of 1945, the Company's aggregate net profits after payment of

[23] On May 5, 1944, John Foster Dulles of Sullivan & Cromwell on May 5, 1944, sent to Snodgrass a preliminary draft of the opinion of his firm, with respect to questions raised by the B. & O. In his opinion Dulles stated that the attitude of the RFC lay "at the foundation of the necessary allegation" that the company was unable to meet its debts and that he assumed that the B. & O. "would have ascertained and honestly believed" that the RFC would not extend its loan except on the conditions outlined in the Henderson letter of April 6, 1944. Upon receipt of a copy of the Dulles opinion, John J. Cornwell, a director and the general counsel of B. & O., read the opinion and made the following notation thereon in ink: "Mr. Clay: Read with interest. Finis! J.J.C." (OX 20, pp. 3419, 3446)

all taxes and fixed and accrued contingent charges totalled approximately $116,000,000.[24] The four years 1941-1944, inclusive, represent the most profitable period in the Company's entire history.

2. During this period the collateral securing the debt to the RFC of roughly $81,000,000 increased in market or appraised value from $70,000,000 to a total of $162,000,000 as of December 26, 1944. At the time of the court's opinion it conceded the collateral a value of $172,000,000 (p. 560 of 63 F. Supp.).

3. During the same period net working capital increased from a *deficiency* of $13,000,000 as of July 31, 1939 to a favorable balance of approximately $68,000,000 as of December 31, 1945 (T. 1892; OX 2 (March), pp. 3505-6).

4. The cash and cash assets as of December 31, 1945, exceeded $83,000,000 compared with only $8,000,000, as of July 31, 1939 (*Id.*).

5. In 1943 and 1944—the year before the RFC loans became due—the Company with the prior knowledge and approval of Hon. Jesse H. Jones, the Federal Loan Administrator used some $31,500,000 in sinking fund and other moneys for the retirement of bonds maturing in the years 1948, 1950, 1951, 1957, 1959, 1990, 1995 and 2000, instead of applying the funds to reduction of the RFC loans. (T. 237, 240, 1292-3; PX 92, 93, pp. 2240-1.)

6. Accruals for depreciation of equipment and amortization of equipment and road properties from 1940 to 1944, inclusive, totaled more than $64,000,000. (PX 42-47, pp. 1582-1727.)

7. In 1944 the B. & O. paid off in cash $23,000,000 of its publicly held obligations maturing in that year, without paying any part of its debt of the same issue to the RFC. (OX 4, p. 3401.)

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[24] See note 12, *supra*. (PX 1, p. 29; PX 88, p. 2011.)

8. The Company obtained a letter from the RFC, dated April 6, 1944, stating that it would extend the debt if modifications were made in other securities similar to those proposed in the present plan. But the facts show that the Company never sought in good faith to secure an extension from the RFC but instead bent every effort to securing as strong a paper record of refusal from the RFC as possible for the sole purpose of supporting a Chapter XV proceeding. For example the RFC was never asked whether it would extend the loan if a substantial payment on account was made. (OX 20, pp. 3428a-3470.)

The facts are in all material respects uncontroverted. The RFC has never in its history foreclosed a railroad pledge or forced a railroad reorganization by refusing to extend a loan. The facts prove beyond doubt that in the instant case it was merely a willing partner of the management, acting particularly through Stewart McDonald, Chairman of the Executive Committee of the B. & O. and one time Deputy Federal Loan Administrator, and R. L. Snodgrass, Vice President of the B. & O. in charge of Finance, and former Assistant General Counsel of the RFC.

Despite the statement of the lower court that it has independently reviewed all the evidence in accordance with the requirements of the Act, its opinion, as well as the record in this case, indicate that the court was so influenced by the volume of assents to the plan and by rising market quotations since it was first announced,[25] as to raise a serious question whether it adequately fulfilled the statutory requirement of scrutinizing the facts "independently of the extent of acceptances of such plan and of any lack of op-

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[25] The entire bond market, as shown by the Dow-Jones averages, rose to new highs in the period in question (PX. 99, p. 2258).

position thereto, and of the fact that the * * * [I. C. C.] * * * has made such or similar findings" (Section 725(3).[26]

We submit that on this record the finding of the court below that the petition for approval of the plan was filed in "good faith" cannot be supported. We submit that the court erroneously applied to the facts the sole standard of "intentional fraud," and that, in view of the excellent financial condition of the Company, the demonstrated policy of the RFC, the enormous amount of salable collateral securing the RFC obligation and the failure of the Company's officers diligently to pursue obvious means of taking care of the RFC maturities, the petition by any proper standards cannot be held to have been filed in good faith. We further submit that it was an obvious fraud in the legal sense upon the jurisdiction of the court for the Company, upon such a flimsy basis, to proceed to effectuate another reorganization in the face of its representations and the same district court's findings and injunction in connection with the 1939 plan. And, finally we submit that unless corrected by this court, the decision below will serve as an encouragement to collusive petitions and will undermine the high standard of reorganization practice insisted upon by this Court and by the Congress. Review by this Court is of importance to the proper administration of Chapter X and Section 77 of the Bankruptcy Act, as well as Chapter XV and successor provisions which are pending passage by the Congress.

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[26] When the original Chapter XV was before Congress Chairman Eastman of the ICC pointed out (see Hearings of the Sen. Com. on Interstate Commerce on H. R. 5407, 76th Cong. 1st Sess. (1939) 62) that consideration both by the Commission and the court of a plan submitted under that chaper would inevitably be affected by the fact that much time and money have already been spent on the plan at the time of its submission to them and that it has been accepted by a substantial number of interested parties. It was undoubtedly in recognition of this influence that Congress imposed upon the court the statutory duty in question.

III.

The court below erred in holding that the petition was properly filed and that the Company was "unable to meet its debts matured or about to mature." In so holding, the court erroneously applied this jurisdictional standard of Chapter XV (§ 710 (3); 11 U. S. C. § 1210 (3)); and as applied by the court to the facts of this case, the limits of the federal bankruptcy power were exceeded.

As we have discussed below and shall further show under this heading, the court's finding of the Company's inability to pay debts matured or about to mature amounts merely to a finding that it was inadvisable for the Company to do so: that it was in the Company's interest, and particularly that of its stockholders, to fail to meet an impending maturity so that it could resort to adjustment proceedings under the bankruptcy power. If such a finding were sustained it would provide a continuing inducement to corporations to resort to the bankruptcy power progressively to shake out the rights of their creditors, whether or not insolvency in the bankruptcy or equity sense exists. This would apply not only to railroads, but also to business corporations generally. Chapter X of the Bankruptcy Act, par. 130(1), 11 U. S. C. 530(1). To translate "inability" to meet debts into "inadvisability" would sanction abuse of the bankruptcy power, and lend the extraordinary sanction of this power to cases where necessity does not exist, and where the very existence of the power is at least doubtful. See *Continental Illinois National Bank and Trust Co.* v. *Chicago R. I. & P. Ry. Co.*, 294 U. S. 648, 673; *Hanover National Bank* v. *Moyses*, 186 U. S. 181; cf. *Canada So. R. Co.* v. *Gebhard*, 109 U. S. 527.

Further, the court's decision on this point permits and invites resort to the courts rather than to normal business methods of meeting debts. Whenever a debtor is dissatisfied with the conditions on which creditors will extend debts, the district court's construction would permit the debtor to make a case for reorganization by detailing the reasons

why it is beneficial to the debtor to reorganize. Such a radical departure in bankruptcy law should not be permitted to stand without review by this Court.

That the standard applied by the court below leads to unjust consequences is obvious from the facts of this case. The petitioner's Convertible bonds are to be stripped of valuable rights because the court below agreed that it was inadvisable for the Company to use any part of its huge, working capital, its swollen cash account, its liquid security-holdings or other resources to pay the RFC, or to permit the RFC to realize upon so much of its collateral as might be necessary.

There can be no question that if the Company had not been bent upon a general adjustment under Chapter XV to improve its equity position, ways could easily have been found to pay or to meet the RFC debt, without prejudice to the Company. Even if we assume that the RFC would have insisted upon payment (which it never did), that could have been made. And certainly, a very substantial payment on account could easily have been arranged, with extension of the balance or its liquidation by sale of collateral; and no party contended that the RFC would have rejected such an offer as against the extension of the entire debt to the RFC under the plan for a period of 20 years. It must be remembered that the Company, driven by its desire to force a readjustment planned at least as early as 1943, never made any such proposal to the RFC.

A brief statement of points will demonstrate the basis for our view that the court merely indulged the Company's desire for readjustment of its debt when it made the finding of inability to meet the RFC debt.

(a) The court below admits that the RFC loan of some $81,000,000 is secured by collateral with a market value of $172,000,000. Yet, it engages in market analysis and asserts that the present market value "is due to the prospect of success of this plan; and the failure of the plan would inevitably substantially impair public confidence in the future

prosperity of the Railroad with the consequent substantial decrease in the market value of the collateral" (p. 560 of 63 F. Supp.).[27] To permit courts generally to make such prognostications the basis for findings of inability to pay cannot but result in substantial deviation from existing standards concerning the application of the Bankruptcy Act and indeed of the scope of the bankruptcy power. Indeed, it is difficult to imagine that any presently foreseeable decline in the market value of the collateral pledged to secure the RFC loan would wipe out the margin between the obligation and the value of the collateral.

There can be no doubt that any contention is insupportable that enough of the pledged collateral could not be sold to satisfy, in whole or in substantial part, the RFC debt. Included in this collateral are certain securities which are not system securities such as the common stock of the reorganized Philadelphia & Reading Coal & Iron Co.; the stock of the Joliet & Chicago R. R. Co., a part of the Alton system; and a minority interest in the stock of the Southwestern Construction Company. These securities were found by the ICC to have an appraised or market value of over $13,000,000 as of December 26, 1944. An additional sum could have been obtained by sale of the certificates of beneficial interest in the 165,544 shares of Western Maryland First Preferred Stock, which had as of the same date a market value of $21,500,000 (PX 3, pp. 91-92).[28]

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[27] The court's statement omits the fact that the entire bond market has risen in this period. The court also omits to note that B. & O. bonds are quoted below the general market as shown by the Dow-Jones indices. (PX 99, p. 2258.) That B. & O. bonds have gone up since announcement of the plan may simply be an effect of the general rise or of their unduly low price prior thereto.

[28] The attitude of the court below is illustrated by its statement that the sale of the Western Maryland preferred "would be utterly disastrous to the unity of the B. and O. System, * * *" (p. 560 of 63 F. Supp.) This is contrary to the finding of the Interstate Commerce Commission, which has held that B. & O.'s ownership of this stock was in violation of the antitrust laws and of the Interstate Commerce Act (160 I. C. C. 785). (This ruling was not affected by the publication of the I. C. C.'s Four Party

It should be emphasized that these are merely illustrative. As Mr. Cassius M. Clay, who resigned as General Solicitor of the road in protest against these proceedings (*supra*, pp. 24-25) said: "I don't think an honest effort was made to meet the maturity in any way" (T. 1255).

Further proof of the Company's ability easily to meet the RFC debt is cited in the following points—

(b) As of December 31, 1945 (before the entry or the decree below), the Company had the largest net working capital it has had in over twenty years—roughly \$68,000,000. As of July 31, 1945, the Company's net working capital was \$51,000,000. (OX 31, p. 3485.) There was \$41,800,000 in cash and \$33,000,000 in cash investments (PX 86, p. 2008). It can hardly be disputed that a large amount of this could be used for application on the RFC debt. In fact, when the plan was before the I. C. C., the net working capital account was \$35,851,859 as of October 31, 1944 (the latest date for which figures were in evidence) which presumably was found by the I. C. C. to be adequate. See statement of Hand, J., *Delaware & H. R. Corporation* v. *Dancey*, 51 F. Supp. 763, at 765. On this basis, it may be assumed that \$15,000,000 from this account as of July 31, 1945, and \$32,000,000 as of December 31, 1945, was available for application to the RFC debt. Indeed, the basis in the record for the court's finding "that no substantial cash sum could fairly be presently withdrawn from current assets to apply on the 1944 maturities" (p. 556 of 63 F. Supp.) is the

Plan for the Eastern Region in July, 1932. 185 I. C. C. 403.) To this ruling B. & O. has submitted without appeal to the Courts, and the stock is trusteed at the Commission's direction (183 I. C. C. 165). No attempt has been made by B. & O. to have the decree vacated or to terminate the trusteeship, or to acquire lawful control of the Western Maryland. 49 U. S. C. 5(2). Furthermore, sale of the First Preferred stock's certificates would still leave B. & O. with all its certificates of beneficial interest in Western Maryland Common and Second Preferred. President Daniel Willard frankly admitted in past years that there was no necessity for B. & O. to own this stock. (See Vol. 5, pp. 3618-9, *Railroad Combination in the Eastern Region*, Senate Report No. 1182, 76th Congress, 3rd Session.)

opinion of Mr. Snodgrass, Vice-President in charge of finance for the Company.[29] Even Mr. Snodgrass' opinion to this effect was based upon an April, 1945, balance sheet, and between that time and July (before the opinion of the court below), net working capital increased by $15,000,000 (PX 48, PX 86, pp. 2008-9), and as of December, 1945 by $32,000,000 (OX 2 (March), pp. 3505-6). The court, however, characterized the first improvement as making the figures "not very greatly different" (p. 556 of 63 F. Supp.). The second improvement was called to its attention but it held that was an insufficient reason for altering "the determination which we reached, and which we expressed in our opinion". It should further be noted that in February, 1945, in proceedings before the I. C. C. in connection with this plan, Mr. Snodgrass underestimated by roughly $50,000,000 the amount of cash and government bonds which would be available as of December 31, 1945 (T. 1990-2002; PX 4, p. 100; OX 2 (March), pp. 3505-6).

(c) We are convinced that if the court had held the management of the Company to the standard of due diligence in endeavoring to meet the RFC debt as a requisite to resort to the extraordinary bankruptcy power, it would have found, merely by reference to the above facts, that the Company could not make the jurisdictional showing of inability to meet its debts matured or about to mature. If further support were needed for this conclusion, mention might be made to other sources of ready cash in addition to those al-

[29] Other witnesses testified it would be "inadvisable" to draw on working capital. None testified B. & O. would be "unable" to apply this capital to meeting the RFC debts. It should further be noted that Snodgrass's opinion that $35,000,000 was reasonably required as net working capital was not supported by the facts as they developed within the next 8 months following April, 1945. The balance sheet items in evidence for June through December, 1945 show that B. & O. actually did not draw down on the capital balance that Snodgrass had testified was needed and that the huge accumulations of net working capital had been maintained idly without being put to productive use. (T. 1893-1896, OX 2 (March) pp. 3493-3506.)

ready mentioned: e.g., sale of $3,500,000 First Mortgage Bonds held in the Company's treasury (PX 1, p. 18); and First Mortgage and Pittsburgh, Lake Erie and West Virginia bonds in the amount of $9,000,000 which were cancelled after tentative approval of the plan by the Company's Board of Directors (OX 6 (March), pp. 3509, 3514-5). And it should also be recalled that, within a relatively short time prior to the RFC maturity, the Company deliberately diverted $31,500,000 of its cash to purchase obligations maturing *after* the RFC debt.

We respectfully submit, therefore, that to permit a corporation to file a petition under the Bankruptcy Act, with the purpose and effect of degrading its obligations, in light of the circumstances of this case, is to condone and invite abuse of the statutory requirement in excess of the bankruptcy power. The flimsy pretext that the Company here was unable to meet its debt to the RFC must not be allowed to foreclose judicial inquiry into the statutory and constitutional basis for invoking the radical power of the bankruptcy court. A clear declaration by this Court of the necessity for unmistakable, non-colorable proof of inability to meet debts matured or about to mature is essential to proper administration of the law and to firm insistence by the courts upon the sanctity of corporate obligations in accordance with law and our constitutional system.

IV.

The court below erred in finding that the plan had been accepted by the requisite percentage of security-holders and that no misrepresentations were made in securing such acceptances. In so holding, it adopted a procedure which creates a dangerous precedent for other reorganizations. It decides a question of importance in the administration of the Bankruptcy Act in a clearly erroneous manner.

(a) The court made the finding required by Section 725 that the plan had been assented to and accepted by the requisite percentage of securityholders. In this it relied

exclusively on a statement by the management and the introduction in evidence of a mass of 39,000 acceptances so arranged that neither the court nor any securityholder could adequately check them. No list of all the affected bondholders was filed. Further, unique among railroad reorganizations, accepting bonds were not deposited nor were they stamped to indicate acceptance. (In the 1939 solicitation, bonds were deposited and certificates of deposit issued by the Company to evidence the accepted bonds.) Under the present scheme a transferee of a bond has no knowledge whether the previous holder has accepted the plan or not and without such notice is, of course, not bound by acceptance by the previous holder.[30] This is important in the light of the large activity in the B. & O. bonds. Thus, within the interval between the date of the management's first letter of solicitation and the entry of the court's decree approving and confirming the plan, more than thirty million dollars of the Convertible Bonds (approximately half of the total issue) were sold on the New York Stock Exchange. Under the circumstance a serious question exists both as to the quality and sufficiency of the proof offered by the management that the assents and acceptance of the various classes of bondholders had been obtained in the percentages required by the statute. Yet the court required no proof of the continued validity of the acceptances filed with it, a procedure which is a dangerous precedent for other reorganization proceedings.

(b) The court further failed to take into account the Company's unfair solicitation practices and in particular, a vital misrepresentation of fact which was used to induce acceptance of the plan.

In the Company's antecedent plan, the court in its decree of November 8, 1939, provided that if the Company should again file a petition "under any provision of the Bank-

[30] Stock brokers were paid for obtaining assents to a plan, but not for dissents. Thus an incentive was created for the purchase of bonds by brokerage houses and for their sale immediately after being assented.

ruptcy Act or other similar law at the time in force," all the interest made contingent by that plan should forthwith become fixed interest. In its solicitation literature the management represented to bondholders whose interest was made either wholly or partially contingent by the antecedent 1939 plan that such interest was *now contingent*. Despite the fact that the management issued letters of solicitation after the filing of its petition with the court below, in such subsequent letters it did not in any way call to the attention of the bondholders that all the interest on their bonds had become fixed by the filing of the petition, so that a grave question exists as to the validity of the assents obtained after the filing of the petition in the instant court proceeding. Since the assents obtained after the filing of the petition of July 2, 1945, are necessary to meet the statutory percentages, a substantial question exists concerning whether the statutory percentages had been attained.[31] Yet although called to its attention the court below did not even mention the matter unless it be included in its general comment that there were no "material" misrepresentations.

CONCLUSION.

This case presents issues of fundamental importance, not only to the 80,000 bond holders of the Baltimore and Ohio Railroad Company, including the 41,000 non-assenters, but also to investors generally. It presents fundamental issues in the administration of the various chapters of the Bankruptcy Act relating to corporate reorganization and of Section 11(e) of the Public Utility Holding Act of 1935.

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[31] Indeed it is probable that the interest became fixed on December 4, 1944 when the petition under Chapter XV was filed with the I. C. C. This was before any soliciting literature was mailed so that the representation of existing contingency of interest was false even when originally made.

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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